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Do Rural Financial Savings Matter?

by

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> "...the principle which prompts to save is the desire of bettering our conditions, a desire, which, though generally calm and dispassionate, comes with us from the womb, and never leaves us till we go to the grave."
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> \- Adam Smith (1776)

Savings mobilization and capital formation were major concerns of development economists until several decades ago when these issues were pushed aside by increasing attention to surplus labor, to creating new technology, and to transferring foreign exchange and food from high to low-income countries (LICs). Concerns with savings mobilization have receded so far into the shadows that a casual reader of recent development literature might conclude credit was the all-purpose developmental anti-biotic and loans ought to be subsidized and savings taxed to promote economic and social progress. Currently, most savings in LICs are involuntarily mobilized through taxation, inflation, overvalued exchange rates, or by tilting terms-of-trade through pricing policies (Gurley and Shaw). Collecting substantial amounts of voluntary savings through financial markets seldom occurs, and savings mobilization is the forgotten half of what financial markets can do in development (Vogel).

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* Ohio State University colleagues, especially Claudio Gonzalez-Vega and Robert Vogel, made substantial contributions to the ideas presented in this essay.

In the subsequent discussion I argue that, for at least five reasons, mobilization of voluntary financial savings has major import for development: it improves resource allocation, it results in more equitable income distribution, it leads to more financial market vitality, it dampens inflation, and it expands economic freedoms. Before discussing these reasons, it is useful to outline how rural financial markets are operating in LICs.

Rural Financial Markets in LICs

With few exceptions, the amounts of savings mobilized by formal rural financial markets in LICs are small. In most LICs these savings are a tiny fraction of the total value of agricultural output, make up a small part of total financial savings, and amount to a small portion of the funds banks have to make formal agricultural loans. Numerous rural financial intermediaries do not offer deposit services, and those that do seldom provide attractive opportunities or incentives for depositors. In most cases intermediaries are mainly retail outlets for funds provided on concessionary terms by central banks, governments, or donor agencies. Interest rates on both loans and savings deposits are often set below rates of inflation so that real rates of interest are negative. Even with these low deposit rates, intermediaries usually find it cheaper to draw loanable funds from central bank concessionary rediscount lines than to promote additional voluntary savings.

Because rural financial markets are typically badly fragmented (McKinnon, Shaw), loan and deposit transaction costs for both intermediaries and clients are relatively large (Cuevas and Graham). This, combined with various regulations, makes it difficult for intermediaries to realize scale or scope economies. It is often in their interests to shift some of their normal loan and deposit transaction costs to clients as ways of rationing access to loans or discouraging deposits by new and small-account clients. Further, in far too many cases, the loan recovery record of the formal intermediary is so atrocious that no saver would voluntarily trust his or her savings to the intermediary in the absence of ironclad deposit insurance.

In part, the lack of concern with mobilizing voluntary financial savings is the result of long-cherished assumptions by policy makers about rural savings behavior. It has been commonly assumed that peasants cannot or will not save in financial form until their incomes reach relatively high levels, and that interest rates do not significantly affect savings behavior (Mikesell and Zinser). The lack of capacity to save has been emphasized to the almost total exclusion of the opportunities and incentives to save (Wai). As a result, low interest rates, inconvenient deposit facilities, and policies that reduce rural incomes abound and effectively asphyxiate financial savings in rural areas. In the few cases where rural people have been provided appropriate savings opportunities and incentives, and left with cash incomes, savings performance, even among the very poor, has been remarkable (Adams).

While there may be justification for some continued agnosticism about the potential capacity of rural people to save, their willingness to express savings in the form of financial deposits, and their responsiveness to interest rates, there should be no doubt about the developmental importance of these financial savings. Policy makers have often considered only direct costs and administrative ease in selecting savings mobilization techniques. It may be very easy, for example, to tax all holders of financial instruments by inflation, and yet, this may have very adverse effects on income distribution, resource allocation, and on other important development activities. While it may take more patience to mobilize economic surpluses through voluntary financial deposits, the indirect effects of doing so are very much worth the effort.

Savings and Resource Allocation

The contribution of financial markets to efficient resource allocation is poorly understood. This is compounded by confusion over the term 'funds', which are financial instruments and generalized-claims-on-resources, and the term 'capital', which is a factor of production. One must clearly distinguish between financial markets and the markets for physical goods if the developmental role of finance is to be understood.

A financial market that offers a broad range of loan and deposit services plays an important, although subtle, role in resource allocation. It does this by transferring claims-on resources among disparate firms and households. Heterogeneity of potential clients of financial intermediaries provides a fertile environment for improving the efficiency of resource use through reallocation of real resources. At any given time some rural decision-making units want to borrow resources to act on attractive consumption or investment opportunities, while other units have exhausted their marginal opportunities and have economic surpluses.

Although some reallocation of resources may occur among contiguous deficit and surplus units through barter and informal financial markets, only a well integrated financial system can connect deficit and surplus units over broad geographic areas and over long periods of time. When financial markets are poorly developed or are repressed, many units in the economy are induced to consume more or to use surpluses in activities that yield low marginal returns. At the same time, deficit units may be forced to forgo investments that have high marginal returns or to pass up consumption alternatives that might yield substantial additional satisfaction. When financial markets are repressed and fragmented by regulations they do a poor job of equalizing the marginal returns of deficit and surplus units. Some units are denied access to loans, others are forced to incur inordinately high borrowing costs, others are denied financial savings services, and still others save less than they would otherwise because of the low returns expected from deposits.

A faulty financial system causes inefficient allocation of real resources, too much consumption, too little investment, and too little production. Because these inefficiencies occur in numerous bits and pieces, they are impossible to aggregate. If these losses could be measured their value would likely represent a much larger amount than all foreign aid currently directed to LICs. Improved savings deposit services in rural areas of LICs would help eliminate a significant part of these inefficiencies.

Savings and Income Distribution

It has recently been shown that low interest rates force concentration of cheap credit into the hands of those who are experienced borrowers, those having collateral, and those with high incomes (Gonzalez-Vega). Since the benefits from credit use, loan default, and the income transfers implicit in negative real rates of interest are all proportional to loan size, financial markets have a major impact on income distribution when interest rates on loans are kept low. This is especially true when inflation is important, when serious loan recovery problems occur, and when formal financial markets are relatively large.

A less well recognized result of low interest rates and fragmented financial markets is their concentrating effect on income distributions via savings (Kane). Typically, fragmented financial markets do little in the way of providing the poor, especially those in rural areas, with attractive savings options. The divisible and liquid features of financial deposits make them a very attractive form of savings for the poor. Since the poor generally have more limited savings alternatives than the rich, those with low incomes who face repressed financial markets are often forced to accept a low return on their deposits, invest in an activity that yields an even lower rate of return, or to consume economic surpluses. Those with higher incomes are much less affected by repressed financial markets. It is relatively easy for them to purchase land, buildings, gold, lend in informal financial markets, or to transfer surpluses overseas. The rich find it easy and inexpensive to evade the implied tax placed on those who hold financial assets when negative real rates of interest are in force. The poor find this evasion to be more difficult and costly. While the poor only lose modest amounts from holding a few funds on deposit at negative real rates of interest, their opportunity costs from the lack of convenient and attractive savings deposit alternatives are large.

Cheap credit is no bargain for the poor because they get very little of it. The lack of savings deposit services and/or low interest rates on deposits are a more direct and important imposition on the poor because they have few other savings options.

Savings and Financial Market Vitality

There are four ways in which aggressive savings mobilization have positive effects on the vitality of financial systems. First, if a financial intermediary is highly dependent on foreign aid or the local government for loanable funds, the intermediary will be very concerned about cultivating the patrons who provide this liquidity. This results in intermediaries spending ample time stroking central bank, donor agency, and government officials, rather than building strong working relationships with their own savers and borrowers. This leaves the intermediary highly exposed to political intrusions. Supporting the party in power by making politically motivated, noncreditworthy loans becomes impossible for the intermediary to resist. If an agency mobilizes, from its own depositors, a large part of the funds that it lends, it will be less prone to these intrusions.

A second, and closely related issue, is loan default. Serious default problems are the common wages of politically stained loans. Political pressures also make it difficult to collect these loans once they are overdue. In extreme cases this may turn the intermediary into a dispenser of political patronage. When this occurs, those who have not received political loans feel less compelled to repay because of others who default. The lack of social sanctions against people who do not repay loans made from government or donor funds also worsens loan collection problems. As loan defaults cascade, the managers of the financial intermediary increasingly spend time trying to resolve these problems, plus trying to milk additional funds out of patrons to sustain lending operations; agency morale and staff efficiency suffer as a result. Locally mobilized savings obviates some of these problems by blocking political intrusions into the loan-making process, forcing managers of financial intermediaries to pay more attention to local depositors, and by changing the ownership-image of the funds lent; it is not socially acceptable to steal a neighbor's money in any society.

A third contribution to intermediary vitality that results from savings mobilization is through the client information it provides. It is easier for a lender to make lending decisions about a potential borrower if that individual has a savings account with the intermediary. Individual savings activities provide the lender with valuable and inexpensive information about potential borrowers. Since there are generally very strong scope economies in financial intermediation, lending to an individual who is also a depositor makes good sense for any lender.

Providing savings deposits can also result in scale economies for the intermediary, and is a fourth benefit. In most well-functioning financial intermediaries, the number of depositors will exceed the number of borrowers at any given time by a factor exceeding 10. If an intermediary does not offer savings opportunities, there will be fewer people passing through the institutions than if it were to offer these services. This limited traffic means that the intermediary has less chance to expand the sale of other financial services. Further, a lender that provides a narrow range of services is less attractive to potential clients. The overall volume of business, and number of clients who want to maintain a working relationship with the intermediary, importantly depend on the range and quality of services provided. These, in turn, are very important determinants of loan repayment performance and the average cost of providing financial services.

Savings and Inflation

An additional reason for mobilizing financial savings is that they lessen inflation pressures. If price increases are caused by expansion in money supplies, voluntary savings can substitute for some of the money printed for agricultural loans. In at least one country, Brazil, massive increases in funds for agricultural credit in the 1970s were a significant factor in rapid growth of the money supply. In sharp contrast to Brazil, the Taiwanese government in the early 1950s pursued a strategy of voluntary savings mobilization to control inflation and to also provide funds for agricultural lending (Irvine and Emery). The Taiwanese were very aggressive in raising interest rates to positive real levels and offering attractive financial savings options, especially in rural areas. This form of mobilizing voluntary economic surpluses was more popular with the general population than various involuntary methods. With less inflation the Taiwanese government faced fewer pressures to make adjustments in exchange rates, wages, and tax rates. This led to more economic and political stability.

Savings and Economic Liberty

The extent of freedom of choice allowed in an economic system largely determines individual liberties in a society. If coercive methods dominate economic choice, individual liberties are severely circumscribed. Economists and policy makers often give individual liberty short shrift in setting development policy. This is particularly true when it comes to choosing ways of mobilizing economic surpluses and stimulating capital formation. If a society values expanding individual freedoms, mobilization of economic surpluses through voluntary financial savings is preferable to the more commonly used involuntary techniques. While a unit of money involuntarily mobilized through taxes is identical to a unit of money deposited voluntarily in a savings account, their import for freedom of choice is poles apart.

Conclusions

Capital formed with internally mobilized savings must be the foundation of economic development, and in mosts LICs the bulk of these savings must come from rural areas. There is no shortcut or substitute for this, including foreign aid. The pace of this formation is largely limited by government and donor policies and not by defects in savings-consumption proclivities. If Adam Smith was incorrect in assuming that most people are born with latent savings capacities, then the battle for development in most LICs was lost before it was begun (p. 324). A major challenge for those interested in stimulating development is to select a mix of policies that will result in more savings and capital formation and have minimal undesirable side effects. If equity, efficiency, and liberty are important social goals, more extensive use should be made of financial markets, especially in rural areas, to mobilize voluntary savings. It is worth remembering that two of the largest banks in the world, the Bank of America and the Caisse Nationale de Credit Agricole were built on small rural savings accounts. Rural financial savings do matter and can contribute a good deal more to development if appropriate policies are adopted.

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